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The Defense Conversion Commission, as part of its study of the effects of reduced defense spending on the economy, requested comments from defense firms and associations. This report summarizes the industry responses on the effect of DoD spending reductions on those firm's business bases, employment, their strategies, and barriers related to transitioning to commercial markets. Barriers frequently mentioned include specialized Government accounting rules, redundant oversight, burdensome regulatory requirements, and tax policies that do not reward investment.

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Gerald T. Kelley

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A Summary of Industry Responses to the Defense Conversion Commission

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Gerald T. Kelley

This paper was prepared as input to the Defense Conversion Commission in the preparation of its December 1992 report, *Adjusting to the Drawdown*. This paper does not necessarily reflect the findings, conclusions, or recommendations of the Defense Conversion Commission, the Department of Defense, or any other Federal department or agency, nor does the Commission necessarily endorse the views expressed herein.

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A Summary of Industry Responses to the Defense Conversion Commission

INTRODUCTION

As part of the Defense Conversion Commission's review of the effects of reduced defense spending on the economy, the Commission sent a letter to approximately 100 defense firms and associations requesting input concerning the effects of DoD spending reductions on those firms' business bases and employment, their strategies and any obstacles related to transitioning to commercial markets, and the role the Federal Government should play in assisting defense industries. A copy of the letter is in the appendix.

By late October 1992, 19 responses to the letter had been received. Of these responses, 4 were from small- and medium-size firms, 13 were from large firms, 1 was from an industry association, and 1 was received from a union local.

From the comments received, no single issue is addressed by a clear majority of the respondents. This applies to the small- and medium-size firms as well as to the large firms. Some issues are mentioned by small groups of firms. Many of the firms mention unique concerns peculiar to themselves or their industry.

The following sections summarize the issues raised by two or more respondents. The companies' names are coded to preserve confidentiality.

SUMMARY

While there is no single overriding issue in the industry comments, several themes are mentioned by groups of firms. A number of firms indicate that their sales and employment have dropped, or will drop, by as much as 50 percent. Several of the firms say they understand that reductions in defense spending are necessary, but they add that the

reductions should be gradual to allow them time to adjust. Some firms do not plan to transition to commercial markets because of the specialized nature of their products or equipment. Some firms appear to be reluctant to move into commercial product markets outside their traditional areas of expertise, in light of the failures of other firms attempting to do that in the past. They feel that the Government must clearly define an industrial base/acquisition policy. Such a policy would help protect critical technologies and ensure that there is a proper mix of industries, technologies, and skills.

The most often mentioned barriers to conversion are as follows: competitive commercial markets; specialized accounting rules that, from industry's view, place a disproportionate share of Government costs on commercial products (thereby making it difficult to commingle defense-related and commercial production); redundant and unproductive oversight; security/secrecy orders placed on products preventing commercial use and export of products; burdensome regulatory requirements that add product cost but no value; and tax policies that do not sufficiently reward investment in new technology.

GRADUAL DEFENSE REDUCTIONS

Four respondents (an industry association, one large firm, and two small-/medium-size firms) recognize the need for defense spending cutbacks, but they say defense funding should be scaled back gradually to give industry time to respond.

Respondent A1 calls for gradual defense spending reductions in a reasonable period of time; they say that market forces will take care of the adjustment and conversion.

Respondent A3 states that they can accommodate, through attrition, a gradual 25 percent reduction in defense spending. Respondent A3 also states that abrupt defense funding terminations will lead to lost jobs.

Respondent I1 requests that funding be reduced gradually to give industry time to respond to the changing economic environment. Respondent I1 also recommends continued funding for "night vision" programs (for which they manufacture equipment).

Respondent M1 says that spending should be reduced, but at a slower rate.

Production Capacity Issues

Capacity is mentioned by four companies (two large and two small/medium).

Respondent C1 states that they have large facilities with excess production capacity and single-purpose equipment, which are not competitive for producing smaller quantities. They believe it is unlikely that the large production plants can accommodate commercial production, although a small C1 division with flexible facilities and equipment has already been successful in transitioning to private-sector work.

Respondent M1 notes that defense cutbacks have created a production overcapacity problem for the commercial markets. Defense firms looking for commercial work have lowered their prices. Respondent M1 also states that a plan to turn excess capacity into a useful resource is needed.

Respondent N1 states that there is excess shipbuilding and repair capacity today, and, compared to commercial shipbuilding capacity, Navy yard capacity is the most costly to maintain. For this reason, respondent N1 contends that Navy construction and repair work should be transferred to private yards. Except for a few critical resources, they say Navy yard shipbuilding and repair capacity should be closed and converted to alternative commercial use, such as small business enterprise zones.

Respondent T4 mentions that tremendous production overcapacity exists in the solid propellant industry because of the cancellation of DoD programs; industry plants do not lend themselves to the development or manufacture of commercial products. Respondent T4 has no plans for using their own plants to manufacture commercial products. Defense cutbacks will reduce T4's employment by about 6,000 people (i.e., 50 percent) between 1991 and 1994.

Funding/Financing

Four firms (three large and one small/medium size) have comments on various funding and financing issues.

Respondent C2 states that the Government should provide financing to aerospace and defense firms to help them export and that the Government should make more innovative use of the Export-Import

Bank. (Currently, the Bank is prohibited from financing the export of defense-related products or services.)

Respondent G1 indicates that they are shifting to civilian agency and aerospace markets. Diversification achieved by supplying consumer markets would require massive structural and cultural changes in marketing, financing, and program management. Respondent G1 mentions that contract financing is a barrier to conversion, but they do not provide any specifics about this idea.

Respondent I1 states that direct Government funding should be used to offset the costs of converting to industrial products and markets.

Respondent N1 states that converting public shipyards to private use would likely require some type of subsidy to the new operator. With the current overcapacity in the industry, that subsidy would be counterproductive to preserving the existing private infrastructure.

ACCOUNTING POLICIES

Four firms (three large and one small/medium size) refer to Government accounting policies in their responses.

Respondent G1 mentions that specialized accounting systems are a barrier to transitioning to commercial activities because the accounting infrastructure must be maintained to continue any level of DoD contracting.

Respondent H1 states that Government accounting regulations are a disincentive to commercialize. Those accounting regulations tend to transfer the overhead costs associated with DoD work into their commercial business areas. That overhead transference cost respondent H1 $1 million in unrecoverable costs in 1991.

Respondent L1 says that they no longer mix commercial work with defense-related work. They say that Government accounting regulations are "mine fields," and that a Government auditor will eventually claim that costs were allocated incorrectly, even if the added commercial work reduces Government costs by absorbing excess capacity. Respondent L1 recommends clarifying Federal accounting rules to allow for incremental pricing of commercial work, when adding such work reduces fixed and overhead costs otherwise charged to the Government.

Respondent N2 indicates that they are separating their commercial work from military work to free their commercial work from disproportionately sharing defense-related costs.

Procurement Issues

Two firms (both large) mention procurement policies in their responses.

Respondent N2 states that continuation of some procurement regulations is inhibiting their ability to diversify; DoD can help by eliminating regulatory requirements that add cost but no value, such as redundant proposal reviews and certifications. Respondent N2 notes that the initiative on Total Quality Management has positive commercial benefits.

Respondent T2 states that the Government can help conversion by transitioning to commercial-style procurement, using non-developmental items (NDIs) and streamlined procurement practices.

Export Issues

Four firms (two large and two small/medium size) mention export issues in their responses.

As previously noted, respondent C2 states that the Government should provide financing to aerospace and defense firms to help them export and should also make more innovative use of the Export-Import Bank. Respondent C2 also recommends reassessing the rules on technology transfer in light of the end of the Cold War.

Respondent G1 recommends that the Government adopt a supportive and active export policy that facilitates expansion into foreign markets.

Respondent H1 notes that the Government denied them export licenses for the sale of older, noncritical technologies.

Respondent M1 says the United States should pursue export opportunities for military equipment and munitions (e.g., selling F-15 aircraft to Saudi Arabia and Taiwan).

Tax Issues

Three firms (all large) mention Federal tax issues in their responses.

Respondent A3 recommends that the Research and Experimental (R&E) tax credit be made permanent. This permanence would help them develop nonmilitary products that might use facilities originally intended for military production. The R&E funding should be directed to generic "precompetitive" technologies. The adoption of "dual-use" technologies should be stressed. Respondent A3 also requests that accelerated depreciation be allowed.

Respondent C2 says revised Federal tax laws that reward investment, innovation, and productivity should be instituted. The current impact of Federal tax law is neutral to negative.

Respondent G1 states that the Government should permit accelerated depreciation of flexible production facilities and provide tax incentives for R&D.

Training

Training is mentioned by four organizations (three large firms and one union).

Respondent A2 dismissed over 1,400 employees during the last 3 years. Many of those talented individuals will be forever lost to the defense industry. Some of them will require retraining for other professions. Respondent A2 is working with local and Federal agencies on retraining; they anticipate a continued need for Government support of retraining efforts.

Respondent C2 sees Government retraining programs as providing a secondary benefit. They believe that the Government should direct its primary effort toward export assistance, revising technology transfer policy, revising tax laws, and reducing oversight.

Respondent T4 states that general training will not help their unemployed workers because of the lack of employment opportunities near their geographic location. Most of respondent T4's facilities are located in geographically remote sites due to their potentially hazardous activities.

Respondent U1 states that it is critical that legislation be passed to help defense workers retrain. They say that opportunities exist in light rail transportation networks; a privately funded "bullet train"; and in environmental/ecological areas such as pollution control, toxic waste disposal, and global warming.

Market Diversification

Three firms (all large) mention market diversification in their responses.

Respondent G1 is aggressively identifying non-DoD markets that fit their capabilities; these capabilities include the production of aerostructures for civilian aircraft, production of truck bodies and delivery vehicles, design and delivery of integrated data processing and information systems, and design and delivery of advanced energy systems. Respondent G1's strategy for defense conversion is a shift to *civilian agency and aerospace markets, not commercialization to create* consumer markets. Diversification by respondent G1 to consumer markets would require massive structural and cultural changes in marketing, financing, and program management. Historically, redeployment of assets to totally unrelated products has been unsuccessful.

Respondent N2's strategy is diversification, not conversion. They plan to continue as a defense contractor. They are separating commercial work from defense-related work to free commercial work from disproportionately sharing defense work costs.

Respondent T4's plants do not lend themselves to development or manufacture of commercial products; respondent T4 does not contemplate using their plants for that purpose. They will diversify into non-Government business by acquiring other companies.

Streamlining Acquisition Practices

Streamlining is mentioned by two organizations (an industry association and a large firm).

Respondent A1 states that the acquisition process should be streamlined and simplified to reduce the non-value-added burdens imposed on industry. They say that the Government should be allowed to buy commercial products using commercial practices. The Defense Conversion Commission should support the efforts of the "Section 800

Law Advisory Panel," whose existence is a major step toward an overhaul of the Federal acquisition process.

Respondent T2 says that the Government could foster conversion by following "commercial style" and streamlined procurement practices, and by using NDIs.

BARRIERS TO CONVERSION

Four companies (three large and one small/medium size) mention barriers to conversion to commercial activity in their responses.

Respondent A3 says that the barriers to transition are the barriers normally found in the competitive aerospace market; they did not elaborate further.

Respondent G1 says that the barriers to transitioning to commercial activities include the existence of specialized accounting systems, redundant oversight reviews, the inflexible system of standards and specifications, and restrictions on communications between buyers and sellers. Respondent G1 also says that the Government could resolve the existing conversion barriers (including recoupment, contract financing, drug-free work force, and the National Industrial Security Program) by using existing *statutory authority*. (DoD has eliminated recoupment of nonrecurring costs for sales of defense items effective for transactions occurring after 7 October 1992.)

Respondent H1 says that secrecy orders placed on their patent applications serve as barriers to commercialization – preventing the use of certain processes and materials outside a Government classified environment. As mentioned earlier, accounting regulations are a disincentive to commercialization, because they transfer costs associated with DoD work into commercial business areas.

Respondent O1 says that the burden of doing business with DoD hurts efforts to increase commercial business. Respondent O1 has set up satellite facilities to escape the DoD environment. Some of their commercial production is still entangled with burdensome Government policies. Respondent O1 has not seen any changes at the grass roots level to indicate that the situation is improving.

APPENDIX

Letter to Industry

DEPARTMENT OF DEFENSE
DEFENSE CONVERSION COMMISSION
1825 K STREET NW, SUITE 310
WASHINGTON, DC 20006

DAVID J. BERTEAU, CHAIRMAN

COMMISSIONERS
CHARLES A. MAY, JR
CARL J. DAHLMAN
L. PAUL DUBE
MICHAEL M. KNETTER
ROBIN L. HIGGINS
DOUGLAS E. LAVIN

Dear

Last April, the Department of Defense established the Defense Conversion Commission. As part of its charter, the Commission will (a) review the impacts of reduced defense spending on the economy, (b) examine the potential for Federal programs to retrain military and DoD civilian personnel for non-defense pursuits, and (c) investigate the potential for cooperative ventures between the Federal Government and companies attempting to transition from defense to commercial activities.

As part of the Commission's review, we are requesting information from defense contractors and industry associations on the effects of defense reductions on the defense industry. The Commission is particularly interested in the effects the cutbacks will have on contractors' business bases and employment, contractor strategies to transition from defense-related activities to commercial pursuits, conditions for expanded reliance on commercial activities, the obstacles companies face in transitioning to these activities, and the appropriate role for the federal government in assisting the defense industry.

The Commission would appreciate hearing your views on these important issues, and any others you believe germane. We would be happy to receive your input in writing, or if you prefer, we will schedule a meeting at our K Street office.

We look forward to your reply. Our address is Defense Conversion Commission, 1825 K Street NW, Suite 310, Washington, D.C. 20006, or call us at (202) 653-0254.

Sincerely,

David J. Berteau

David J. Berteau
Chairman